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Research Report: Market strategy

## Irish economy and bond market

### A medium-term path to debt sustainability

#### Flexible Irish economy in recovery mode

- Ireland once again displaying its innate flexibility, a painful adjustment process now sowing the seeds of a slow but sustainable recovery.
- Twin-speeded rebound for now, with net export vibrancy offsetting weak domestic demand, but the latter close to an inflection point as sentiment metrics stabilise.
- Sustainable real growth rate still close to 3% in the medium term, comparing more than favourably with Euroland peers.

#### Bank restructuring to support recovery

- Banking system undergoing a "deep restructuring", its downsizing rendering it fit for purpose for the gradual revival in credit demand.
- Deleveraging to reduce monetary reliance and state guarantees, the disentanglement of sovereign and bank credit risks then finally completed. ECB funding support to be sustained throughout the deleveraging process.

#### Debt sustainability achievable, affordable and deliverable

- Stabilisation of debt/GDP ratio eminently achievable on the basis of the existing fiscal consolidation plan, real economy productive potential and ongoing funding support from EU/IMF.
- The servicing burden of accumulating government debt remains contained by historical comparison.
- The requisite scale of budgetary adjustment is considerable (albeit substantially delivered), while the domestic political commitment to fiscal discipline is robust, and the social consensus is accepting.

#### Sovereign liquidity risk still masquerading as solvency risk, but debt market struggling for investor interest as ESM uncertainties abound

- Irish bond market broken protem, bereft of any natural investor base and thereby condemned to scant liquidity and exceptional volatility. Signalling inferences (regarding default risk) now hugely distorted.
- Renewed Greek travails clearly forestalling any investor recommitment to peripheral markets, the enduring Euroland debt crisis now more at risk of a governance crisis.

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#### Please refer to important disclosures at the end of this report.

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## Instability endures in the euro currency area

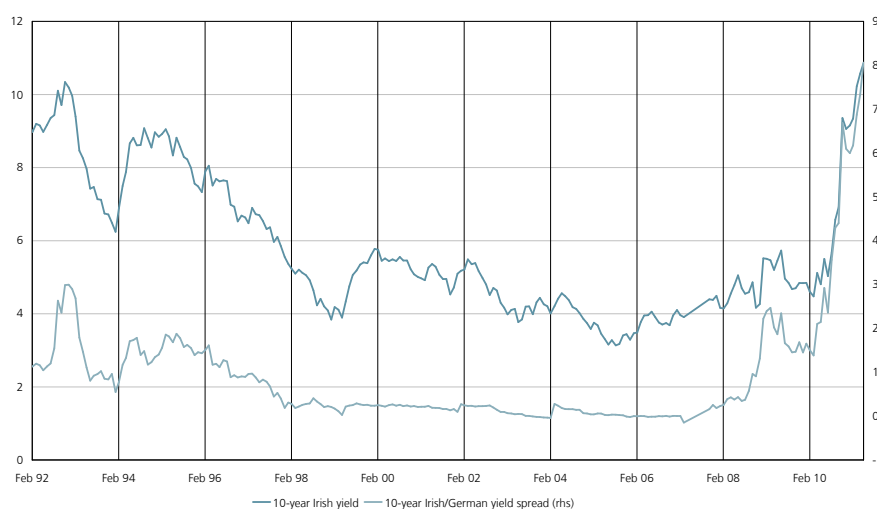
### Irish bond yields trumping early 1990s peaks

It is a sobering thought that the current yield on ten-year Irish government bonds, at 10.85%, broadly matches that endured during the height of the currency crisis in the early 1990s. Worse, the spread over benchmark German bunds is more than twice that observed during this particular period.

Twenty years ago, the exchange-rate mechanism of the EMS was an inherently unstable affair. It comprised fundamentally strong and weak currencies, with the latter susceptible to ongoing devaluation (i.e. realignment) risk, and all the more so if subjected to speculative attack.

Twenty years on, and currency risk has ostensibly been removed by the advent of the eurozone. However, EMU itself is now also inherently unstable, comprising fundamentally strong and weak sovereigns, the latter susceptible to devaluation (i.e. reprofiling/rescheduling/restructuring) risk, and all the more so if subjected to speculative and/or political attack.

Figure 1: Irish ten-year yields and spreads



Source: Bloomberg

- The Euroland sovereign debt crisis may have passed its peak, thanks to the unprecedented policy interventions of the past 12 months

- However, the crisis has rumbled on amongst the weakest peripheral sovereigns

To be sure, the Euroland sovereign debt crisis may have passed its peak, thanks to the unprecedented policy interventions of the past 12 months. Contagion effects in the foreign exchange and money markets have clearly dissipated, while the Spanish/German yield spread, viewed by many as a systemic "line in the sand", now trades in a volatile but relatively contained pattern.

However, the crisis has rumbled on amongst the weakest peripheral sovereigns, with Greece, Portugal and Ireland being condemned to unsustainably high bond yields, and with chronic market illiquidity and volatility a clear impediment to any meaningful investor re-engagement.

- The challenges faced by the Greek authorities are clearly the most extreme, but the pricing signals emanating from cash and CDS markets imply greater than 50% default probabilities for all three sovereigns over the next five years

- The question of Ireland's potential participation in the ESM, and under what pre-conditions, will not be resolved for at least another two years

- Forward-looking debt sustainability analysis requires an assessment of the likely interplay between fiscal policy, the macro economy and financial market developments
- A sober assessment of Ireland's debt sustainability prospects suggests that the requisite scale of fiscal adjustment and nominal growth trajectory is eminently achievable on the basis of the existing fiscal consolidation framework and the economy's latent recovery potential

Persistent market concerns surrounding these sovereigns are based on the perceived unsustainability of their respective debt burdens, despite the draconian fiscal consolidation programmes underway in all three nations as part of their EU/IMF commitments. The challenges faced by the Greek authorities are clearly the most extreme, but the pricing signals emanating from cash and CDS markets imply greater than 50% default probabilities for all three sovereigns over the next five years.

### European Destabilisation Mechanism (EDM)?

Perversely, such elevated default expectations are in part a by-product of EU policy interventions themselves. The term-sheet for the permanent European Stabilisation Mechanism (ESM), which replaces the current European Financial Stability Facility (EFSF) from mid-2013 onwards, has raised the spectre of private creditor "bail-in" as a pre-condition for future loan assistance for distressed Euroland sovereigns. The draft ESM term-sheet is suitably ambiguous regarding private creditor risk, with "the nature and extent of this involvement to be set on a case-by-case basis and to depend on the outcome of the debt sustainability analysis, in line with IMF practice, and on the potential implications for euro area financial stability".

However, the response of bond market participants has been anything but ambiguous. Restructuring risk-premia are being added ex ante to the bond yields of Greece, Portugal and Ireland, on the self-fulfilling expectation that these sovereigns will remain debarred from private market refinancing at "manageable" interest rates, and therefore will stay trapped in the EFSF ahead of the latter's replacement by an altogether more threatening ESM. Meanwhile, an unseemly spat between the EU and ECB over a proposed "reprofiling" of Greek debt risks a governance crisis at the heart of Euroland officialdom.

### Ireland's path to debt sustainability

The question of Ireland's potential participation in the ESM, and under what pre-conditions, will not be resolved for at least another two years. In the meantime, attention will increasingly focus on the nature and extent of Ireland's economic recovery, and of the impact of same on the public finances. Attention too on the planned "deep restructuring" of the domestic banking system, its downsizing aimed at rendering the system "fit for purpose" for the ultimate revival in credit demand.

Stabilisation of Ireland's debt/GDP ratio over the medium term will be a key benchmark deployed by EU/IMF in evaluating sovereign solvency. A stable ratio will ultimately require nominal growth rates in line with debt servicing costs, or less if primary budgets (ex interest payments) move into surplus. Accordingly, forward-looking debt sustainability analysis requires an assessment of the likely interplay between fiscal policy, the macro economy and financial market developments.

A sober assessment of Ireland's debt sustainability prospects suggests that the requisite scale of fiscal adjustment and nominal growth trajectory is eminently achievable on the basis of the existing fiscal consolidation framework and the economy's latent recovery potential. Doubtless, bond market investors will adopt a "wait-and-see" approach in this respect, not least against the prevailing backdrop of heightened sovereign default tensions. Scepticism will likely also endure within Irish public debate, the nation's ability to service its debt burden oftentimes confused with its willingness to.

**"Ireland is different"**

Meanwhile, the contagion effects of Greek restructuring risk continue to ensnare the Irish bond market, reinforced by Moody's forewarning that any "event of default" by the Hellenic Republic may trigger further rating downgrades across the Euroland spectrum. In contrast, S&P views Ireland's economic and financial prognosis very differently to Greece, believing that "the story needs to be told" to sceptical financial markets that Irish sovereign default is far from inevitable. Let the story unfold!

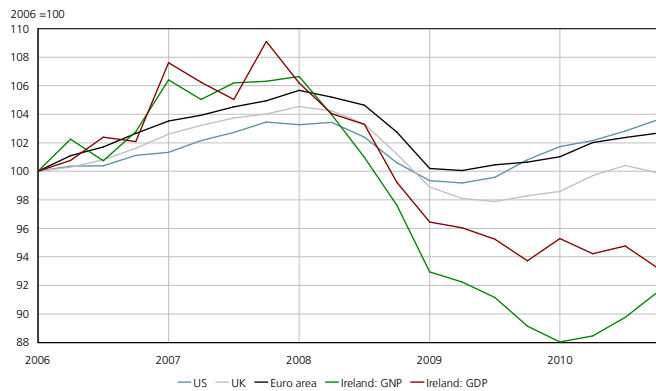
## Evidence points to continued recovery, albeit export-led in 2011

### Choppy pattern of GDP growth masks underlying recovery in the Irish economy

Figure 2 illustrates that the pattern of GDP growth was erratic through 2010 with two quarters of positive growth and two quarters of negative growth. In contrast, there was a far more consistent and stronger pick-up in real GNP. GNP finished the year 4.0% higher than in the first quarter of 2010.

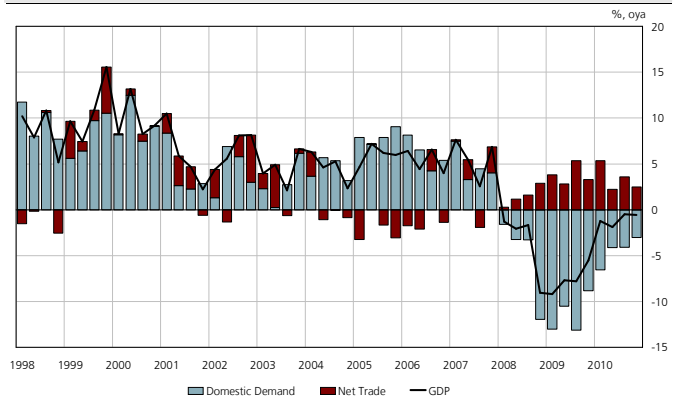
However, the pattern of growth was sharply divided between the buoyant export sector, which grew by 9.4% in 2010, and the stagnant domestic-facing sectors (see Figure 3). Consumer spending and investment both contracted in 2010.

Figure 2: Irish GDP, 2009 = 100



Source: Central Statistics Office

Figure 3: Irish GDP growth, expenditure contributions



Source: Central Statistics Office

- The Q4 GDP figures provided a confusing picture of the underlying strength of the Irish economy

The Q4 GDP figures provided a confusing picture of the underlying strength of the Irish economy – GDP fell by 1.6% but GNP rose by 2.0% on the quarter. Furthermore, nominal GDP declined by 6.4% and net factor payments by 37.6% so that nominal GNP rose by 3.6%. This erratic pattern of GDP and GNP figures relates to very large payments for imports of business services by the multinational sector that are not expected to be repeated in Q1. GDP growth is likely to rebound in Q1, in line with net factor payments, but this is dependent on the large assumption that there are no revisions to the GDP data.

Activity in the Irish economy may also have been affected by the particularly bad weather in December. As in other European countries, the snow-related disruption appears to have pushed down on economic activity temporarily in Q4 and is therefore likely to flatter the quarter-on-quarter GDP growth rate in Q1 (to be published in late June). In addition, heightened uncertainty around the time of the EU/IMF negotiations may have led households and companies to postpone spending.

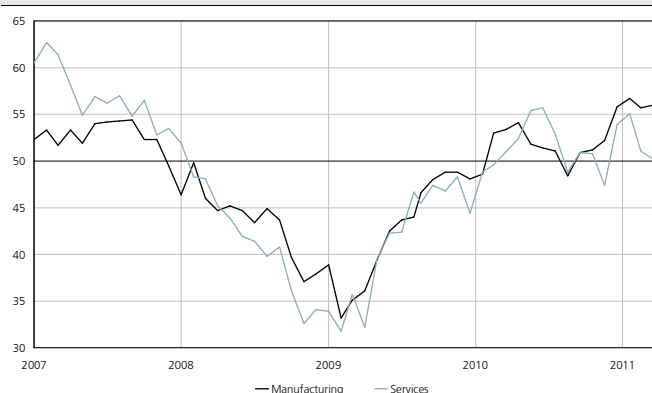
- Given the erratic pattern in the national accounts data, the underlying strength of the economy is probably better captured by the PMIs for Ireland
- Within the manufacturing and services sectors, the PMI surveys indicate that export orders continue to outperform overall output

### PMI data point to positive GDP growth in Q1

Given the erratic pattern in the national accounts data, the underlying strength of the economy is probably better captured by the Purchasing Managers Indices (PMI) for Ireland (available on a monthly frequency). In Q1, the manufacturing PMI output and employment balances rose to their highest levels since 2000 (Figure 4). Manufacturing output should expand sharply in the first quarter.

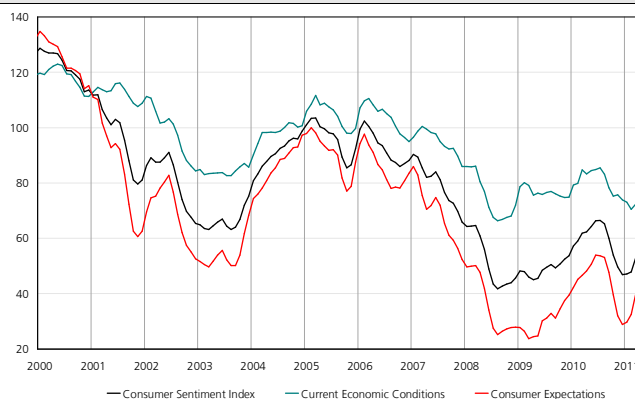
The services PMI picked up sharply in Q1, perhaps because of a weather-related bounce from the poor December number. But the services PMI fell back in April to just above 50 (the no change level). Within the manufacturing and services sectors, the PMI surveys indicate that export orders continue to outperform overall output.

Figure 4: Ireland Purchasing Manager Indices



Source: Markit Economics.

Figure 5: Irish consumer confidence



Source: Central Statistics Office,

- Although confidence rebounded in Q1, consumers are likely to maintain high levels of savings for precautionary reasons

### But domestic demand likely to remain weak

Consumer confidence fell sharply in the second half of 2010 as the IMF/EU deal was negotiated. Although confidence rebounded in Q1, consumers are likely to maintain high levels of savings for precautionary reasons given worries about future access to finance and employment prospects. A sharp fall in household savings rates, from double-digit figures, therefore appears unlikely. Consumer spending is likely to remain weak as real incomes are eroded by the tax and spending plans in Budget 2011; the recent rise in CPI inflation, driven by higher energy prices; and the potential for ECB rate hikes to feed into higher mortgage interest costs.

- Investment spending is likely to pick up only slowly

Investment spending will be held back by limited access to finance, particularly for small firms. Access to finance may improve gradually, and companies are likely to intermediate away from bank loans by reinvesting their profits. However, this adjustment process will be difficult, and investment spending is likely to pick up only slowly.

- The strength of the export sector largely reflects the improvement in Ireland's unit labour costs

- Ireland had a current account surplus in H2 2010 equal to 2.6% of nominal GDP

- That the Irish economy has secured external balance suggests that the bulk of the required adjustment in domestic demand has now passed

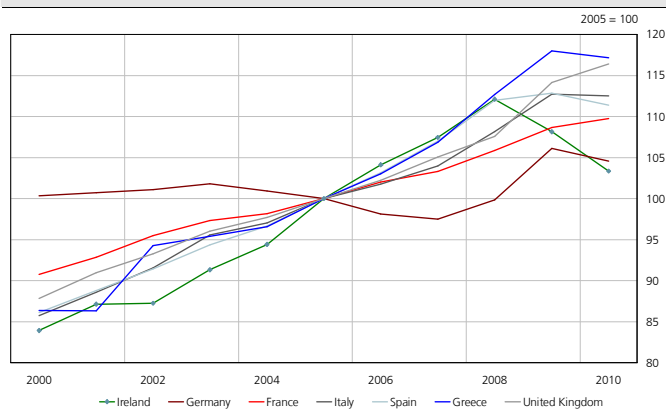
### The bulk of the adjustment in domestic demand has most likely been completed

The strength of the export sector largely reflects the improvement in Ireland's unit labour costs. The EU Commission estimates that Ireland's real effective exchange rate, based on unit labour costs, has depreciated by 10% since Q4 2008 – a very substantial improvement in competitiveness. Figure 6 illustrates that the adjustment in Ireland's unit labour costs has outpaced that of other peripheral European economies. Falling unit labour costs have been secured through weak nominal pay, robust labour productivity and as inefficient sectors within the economy have contracted.

Inevitably, the improvement in competitiveness has been associated with weak domestic demand. However, one positive aspect of this adjustment has been the improving current account balance. Ireland had a current account surplus in H2 2010 equal to 2.6% of nominal GDP – implying an improvement in the net foreign asset position.

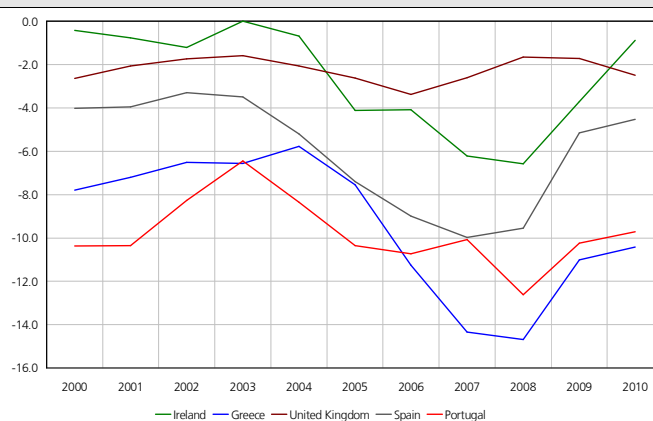
As other peripheral European economies continued to accumulate financial liabilities by running current account deficits (see Figure 7), overall debt levels declined in the second half of 2010 as the Irish economy ran a current account surplus. Of course, government debt continues to rise in line with the fiscal deficits recorded in recent years, but high corporate and household saving has led to a sharp improvement in private sector balance sheets. That the Irish economy has secured external balance suggests that the bulk of the required adjustment in domestic demand has now passed.

Figure 6: Unit labour costs



Source: Datastream; Economic and Social Research Institute, Dublin

Figure 7: Current account balances



Source: Eurostat

### Economic forecasts envisage similar pattern of growth

Table 1 illustrates Irish GDP projections ranging from 2.0% to 0.6% for 2011. However, much of the disparity between the projections reflects the difficulty in forecasting net factor payments. As already discussed, these payments fell by 37.6% in Q4 2010 because of unusually large imports of business services by the multinational sector. We expect that decline to be temporary. The Department of Finance's GNP projections for 2011 are for growth of 0.3%, similar to our GNP forecasts of 0.6%, and the ESRI expects GNP growth of 0.5%.

**Table 1: GDP growth projections (%)**

	2011	2012	2013
Davy	1.6	2.4	na
Economic and Social Research Institute	2.0	3.0	na
Department of Finance	0.8	2.5	3.0
European Commission	0.6	1.9	2.4
International Monetary Fund	0.6	1.9	2.4
Organisation for Economic Cooperation and Development	0.0	2.3	na

Source: Davy; ESRI Quarterly Economic Commentary Spring 2011; Department of Finance, Ireland Stability Update April 2011; European Commission: The Economic Adjustment Programme for Ireland Spring 2011 Review; International Monetary Fund, Country Report No.11/109

There is also a similar configuration for the spending contributions to GDP growth across forecasts, with the export sector remaining robust but with domestic demand (consumer spending and investment) only picking up gradually. The big picture is that GNP growth rates of around 0.5% in 2011 imply a very modest pick-up in economic activity as domestic demand is buffeted by the sharp fiscal adjustment.

Despite the broad consensus around the short-term outlook, it is clear that the prospects for economic growth are especially uncertain. A sharp slowdown in global demand would be detrimental to Irish export prospects. But Irish exports could also benefit from the improvement in competitiveness and to a greater extent than assumed in economic projections. Further problems in European sovereign debt markets pose the risk of a renewed deterioration in global financial conditions. That said, a more credible and comprehensive policy response to the European debt crisis could potentially have a very positive impact on confidence and spending in the short term.

#### More sanguine medium-term outlook

In the medium term, the IMF, the EU Commission and the Department of Finance all believe that the sustainable growth rate for the Irish economy is close to 3.0%. This is a key judgement in assessing the likely trajectory of Ireland's general government debt to GDP ratio. A 3.0% sustainable growth rate for GDP could be derived by assuming that employment may grow at around 1.0% per annum and labour productivity by 2.0%.

Certainly, the high rate of unemployment of circa 14% indicates that there is ample room for employment to expand. Although emigration flows are clearly detracting from the Irish labour force, these flows could quickly reverse if employment opportunities appear. Furthermore, the natural increase in the Irish labour force is relatively favourable compared with other European countries. So the Irish economy could sustain 1.0% employment growth in the medium term.

In past decades, Irish labour productivity growth exceeded 2.0% in the private sector. That said, whole economy productivity growth had been held back by the expansion of the construction sector where labour productivity has performed poorly. Going forward, the growth of labour productivity will be pushed up as the construction sector lags behind and as public sector employment diminishes as a share of employment. In summary, a 3.0% sustainable growth rate seems a reasonable assumption to judge Ireland's debt sustainability.

- Despite the broad consensus around the short-term outlook, it is clear that the prospects for economic growth are especially uncertain

- In the medium term, the IMF, the EU Commission and the Department of Finance all believe that the sustainable growth rate for the Irish economy is close to 3.0%

## Assessing the budgetary arithmetic

### Budgetary adjustments plan to close the government deficit by running a primary budget surplus

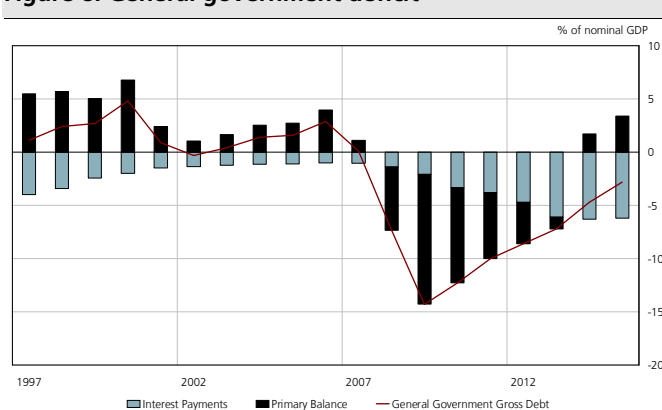
It is worth pointing out that the bulk of the planned budgetary adjustments have already being implemented (see Table 2). The National Recovery Plan envisaged a €15bn adjustment, €6bn of which was set out in Budget 2011, with a further €9bn to come by 2014. These additional €9bn cuts are considerably smaller than the total €21bn implemented since 2008. That said, the spending cuts and tax increases in Budget 2011 have yet to be fully felt by the Irish economy as they are being implemented through this year (see our research report, "[National recovery plan 2011-2014](#)," issued November 25th 2010).

**Table 2: Budgetary adjustments implemented thus far**

July 2008	€1.0bn	Savings focused on public sector payroll
Budget 2009	€2.0bn	Income levy and public expenditure cuts
February 2009	€2.1bn	Public sector pension levy
	€1.0bn	Public sector pay freeze
April 2009	€3.5bn	Tax measures
	€1.8bn	Cuts to government expenditure
Budget 2010	€4.0bn	Cuts to government expenditure
Budget 2011	€6.0bn	Concentrated on government expenditure cuts
<b>Total</b>	<b>€21bn</b>	

Source: Department of Finance  
National Recovery Plan: Further €9bn of cuts by 2015.

**Figure 8: General government deficit**



Source: Ireland, Stability Programme Update, April 2011

- The general government deficit is expected to equal 10% of nominal GDP in 2011 and gradually decline to 2.8% in 2015

Figure 8 illustrates the projections of the Department of Finance for the general government deficit, comprising interest payments on the national debt and the primary balance. The general government deficit is expected to equal 10% of nominal GDP in 2011 and gradually decline to 2.8% in 2015. This improvement reflects a rise in interest payments from 3.8% of nominal GDP in 2011 to 6.2% in 2015, offset by an improvement in the primary balance from a 6.2% deficit in 2011 to a surplus of 3.4% in 2015. Thus far, exchequer returns for the first four months of the year indicate that the plans set out in Budget 2011 are broadly on track.

### Current EU/IMF plan provides sovereign funding up to the point where European Stability Mechanism (ESM) replaces the European Financial Stability Fund (EFSF)

How will these deficits be funded? Table 3 illustrates the financing needs of the Irish government, including the cost of PCAR/PLAR assessment to the exchequer, and how these needs are met by the EU/IMF financing plan.

**Table 3: Government financing needs and funding (€bn)\***

	2011	2012	2013	Total
Government borrowing	31.3	22.7	23.4	77.4
Bank recapitalisation costs	19.0	0.0	0.0	19.0
<b>Financing needs</b>	<b>50.3</b>	<b>22.7</b>	<b>23.4</b>	<b>96.4</b>
Market financing	1.4	3.4	14	18.8
Internal resources (NPRF)	10.5	0.3	-0.6	10.2
EU/IMF funding	38.5	19	10	67.5
<b>Funding</b>	<b>50.4</b>	<b>22.7</b>	<b>23.4</b>	<b>96.5</b>

Source: EU Commission, The Economic Adjustment Programme for Ireland, Spring 2011 Review. \*The EU Commission document assumes cash balances remain at €12bn through 2011-2015.

The EU/IMF plan originally provided €85bn of funding split between €50bn for sovereign funding and €35bn to meet the costs of the PCAR/PLAR exercise. The €35bn included a €17.5bn contribution from the Irish state's internal resources (the National Pensions Reserve Fund and cash balances). The total EU/IMF contribution was €67.5bn.

Following the publication of the PCAR/PLAR exercise, the total cost of meeting the requirements is expected to be €24bn, somewhat lower than the €35bn provided. To meet this cost, the government now plans to borrow €10bn from the EU/IMF fund. The recent stability update confirmed that the remaining €7.5bn of the €17.5bn contributed by the IMF/EU for the PCAR/PLAR exercise will be available for sovereign funding. This means that the sovereign is now funded, without recourse to international bond markets, until early 2013.

Table 3 illustrates that the current EU/IMF plan envisages Ireland acquiring €14.0bn of private funding in 2013. That said, at end-2010 the state had €16.2bn of cash balances that could be used for sovereign funding. The Irish sovereign is now close to being fully funded up to the point where the ESM replaces the current funding arrangements from the EFSF and IMF.

**Current fiscal adjustment plan clearly not predicated on market bond yields, so ESM funding appears the more likely path**

- At the current juncture, it seems likely that Ireland will require ESM funding rather than returning to private markets

At the current juncture, it seems likely that Ireland will require ESM funding rather than returning to private markets. That said, conditions may change materially by 2013. If ESM funding is required, Ireland will undergo a Debt Sustainability Analysis (DSA). Neither the IMF nor the EU provides a clear unambiguous definition of what characterises fiscal sustainability. For the purpose of this analysis, we assume sustainability implies a stable debt to GDP ratio in the medium term, where the sovereign is able to meet the interest costs on the national debt. So would Ireland pass such a sustainability test?

Table 4 illustrates the assumptions underlying the Department of Finance's projections. To stabilise the debt/GDP ratio, a country needs to run a primary balance sufficiently large to offset the gap between the interest payments on its debt and the nominal GDP growth rate. Table 4 illustrates that the budgetary projections envisage a positive primary balance in 2014 and 2015 to accommodate interest payments equivalent

to around 6% of nominal GDP and given a nominal GDP growth rate around 4.0% so that the debt/GDP ratio stabilises.

**Table 4: Assumptions underlying official projections of gross government debt**

	<i>Interest payments</i>	<i>Nominal GDP</i>	<i>Primary balance</i>	<i>Implicit interest rate on debt</i>	<i>Real GDP</i>	<i>GDP deflator</i>	<i>Debt/GDP</i>
	% GDP	% change	% GDP		% change	% change	ratio
<b>2010</b>	3.3	-3.6	-29.2	4.8	-1.0	-2.6	96
<b>2011</b>	3.8	1.4	-6.2	4.0	0.8	0.6	111
<b>2012</b>	4.7	3.1	-3.9	4.4	2.5	0.5	116
<b>2013</b>	6.1	4	-1.1	5.5	3.0	1.0	118
<b>2014</b>	6.3	4.3	1.7	5.6	3.0	1.3	116
<b>2015</b>	6.2	4.6	3.4	5.6	3.0	1.5	111

Source: Department of Finance, Stability Update, April 2011

Can Ireland sustain nominal GDP growth of 4.0% in the medium term? The official projections imply inflation, as measured by the GDP deflator, of around 1% in 2013 and 2014. This assumption looks relatively conservative given the European Central Bank's target for CPI inflation of 2% or below.

As already discussed, the IMF/EU and Department of Finance projections all assume a medium-term real GDP growth rate of around 3.0%, which does not appear an unreasonable assumption. In the near-term, however, adverse demand conditions – as the economy struggles to adjust to the fiscal consolidation – mean that growth is likely to fall short of the 3.0% growth rate. But the supply side of the Irish economy could sustain a 3.0% GDP growth rate given the right demand conditions.

#### **Debt interest burden for Ireland expected to peak at far lower levels than in the 1980s**

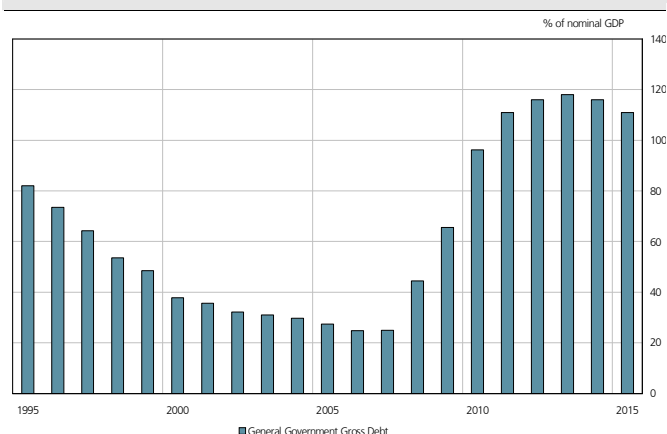
Table 4 illustrates that the implicit interest rate on Irish government debt rises to 5.6%, a little below the current interest rate on borrowing from the EFSF. Given that current Irish bond yields are in excess of 10%, a sharp improvement in market funding conditions would be required to acquire such an interest rate in private markets. Rather, it is more likely that Ireland will require funding from the ESM from 2013 onwards.

Given a 5.6% interest rate, the Irish economy should be able to achieve a primary balance and nominal growth of 4.0% to stabilise the debt/GDP ratio. The planned adjustment in the primary balance is of similar magnitude to that achieved in the 1980s. So, at least within the Irish political sphere, such fiscal adjustments appear achievable.

Figure 10 illustrates the projected debt servicing costs on the national debt given the interest rate profile in Table 4. Although, debt service costs rise to 20% of tax revenue, this figure is considerably lower than the 35% peak in the mid-1980s. While clearly not a pleasant feature of the official projections, this debt burden does not appear unsustainable. Hence, Ireland is likely to pass a debt-sustainability analysis when it seeks funding from the ESM.

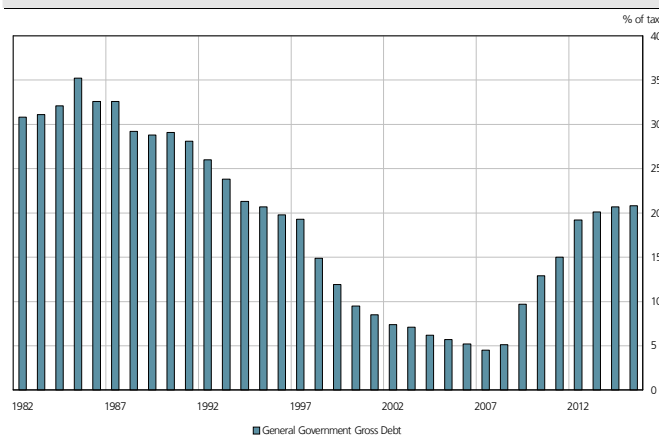
- Given a 5.6% interest rate, the Irish economy should be able to achieve a primary balance and nominal growth of 4.0% to stabilise the debt/GDP ratio
- Ireland is likely to pass a debt-sustainability analysis when it seeks funding from the ESM

Figure 9: General government gross debt



Source: Department of Finance, April 2011 Stability Update

Figure 10: Debt interest as percentage of tax revenue



Source: Department of Finance, April 2011 Stability Update

- As long as Ireland can borrow at rates close to the ECB policy rate, the interest burden on the national debt appears manageable

A criticism often made of the medium-term fiscal projections is that the nominal growth of the economy will not match that of the 1980s period. Hence, it will be more difficult to erode the nominal debt to GDP ratio. However, the corollary of lower inflation and nominal growth has been a sharp decline in Central Bank policy rates. As long as Ireland can borrow at rates close to the ECB policy rate, through either the EFSF or ESM, the interest burden on the national debt appears manageable. A reduction in the interest rate on Ireland's funding from the EFSF would help significantly in convincing markets that Ireland can stabilise its debt to GDP ratio by improving the trade-off between nominal growth and the interest payments on the national debt.

In many economies, household debt to income ratios have risen sharply over the past two decades. The trend decline in nominal interest rates has allowed households to pay interest costs on much higher levels of debt. In the US, this process went too far as households were encouraged to believe that the Federal Reserve would keep interest rates at extremely low levels for a far longer period than was likely. Clearly, many US households were unprepared for increases in the Federal funds rate.

Nevertheless, nominal interest rates did fall sharply through the 1990s as central banks successfully brought inflation under control. Hence, as with households, it may take time for markets to focus on sovereign interest costs rather than overall debt levels.

### Structure of ESM funding likely to impede the re-entry of the sovereign into international bond markets

- The current fiscal projections suggest that Irish sovereign funding will be provided by the EFSF/ESM in the medium term

The current fiscal projections suggest that Irish sovereign funding will be provided by the EFSF/ESM in the medium term. This support means that markets will be unable to force default by the sovereign by denying liquidity. But the Irish sovereign's funding is dependent on the political will within the EU to maintain that funding, which is clearly proving difficult for markets to assess given conflicting signals emanating from EU policy circles.

- Once ESM funding is put in place, the key question will be how the sovereign can re-enter international bond markets

A period of uncertainty and inertia therefore seems likely up until the point where ESM funding is secured in 2013. Once ESM funding is put in place, the key question will be how the sovereign can re-enter international bond markets. For now, a clear re-entry strategy is not apparent, and key features of the ESM provide a substantial disincentive for investors to re-engage with the Irish sovereign. Private investors will be junior to ESM funding of sovereign debt and, if the fiscal position is judged to be unsustainable, the ESM formalises a process for private sector burden sharing.

The IMF has drawn attention to the deficiencies within the EU policy response to the debt crisis. First, funding support for both the banks (by the ECB or ESCB) and the sovereign (through the EFSF/ESM) needs to be put on the right terms so that private investors can re-engage. More clarity and an explicit commitment to maintain funding support over the medium term are required to allay investors' fears. The lack of such a commitment encourages investors to question how the sovereign can re-engage with international bond markets. If there is no exit strategy from the ESM, investors can only question the political will to maintain that support.

**Table 5: Projections for public finances (% GDP)**

	2011	2012	2013	2014	2015
<b>General government balance</b>					
Davy	-9.6	-7.8			
ESRI	-10.0	-8.5			
DOF	-10.0	-8.6	-7.2	-4.7	-2.8
EC Commission	-10.5	-8.8	-7.6	-5.2	-2.9
IMF	-10.6	-8.9	-7.4	-4.9	-4.4
<b>General government debt</b>					
Davy	108.8	113.6			
ESRI	111.0	116.0			
DOF	111.0	116.0	118.0	116.0	111.0
EC Commission	112.0	117.9	120.6	119.2	115.6
IMF	111.1	116.7	120.1	119.8	118.7

Source: Davy; ESRI Quarterly Economic Commentary Spring 2011; Department of Finance, Ireland Stability Update April 2011; European Commission: The Economic Adjustment Programme for Ireland Spring 2011 Review; International Monetary Fund, Country Report No.11/109

## Banks restructured to assist a recovery

### Burden on state finances appears to be over

Once the banks are recapitalised in line with the recently prescribed stress test targets, this will take cumulative state capital support to the Irish banks to a total of €65bn or 42% of 2010 GDP. Despite previous unsuccessful attempts to recapitalise and restructure the Irish banking system, we believe the latest attempt will bring the process to its final conclusion.

- The latest restructuring attempt of Irish banks will bring the process to its final conclusion

Solvency for the systemic banks looks assured due to conservative loan-loss assumptions, higher capital thresholds, contingency capital and deleveraging plans. The four systemic banks are to be recapitalised by the end of July, and the guided €5bn of contribution from liability management exercises towards the banks' €24bn recapitalisation appears on track. In addition, according to official commentary, further capital requirements for the non-systemic banks, Anglo Irish Bank and Irish Nationwide Building Society (INBS), will be minimal (if at all).

- According to official commentary, further capital requirements for the non-systemic banks, Anglo Irish Bank and INBS, will be minimal (if at all)

The continued funding support from the ECB is essential such that the stress testing can be used as a foundation for the banks to move forward and assist rather than impede a domestic economic recovery. Monetary reliance will remain significant as banks' ability to access market funding will remain restricted as the sovereign remains shut out of the market. Customer deposits will take time to stabilise, and the aggressive rule-changing approach towards subordinated bondholders will limit investor appetite when the funding markets improve.

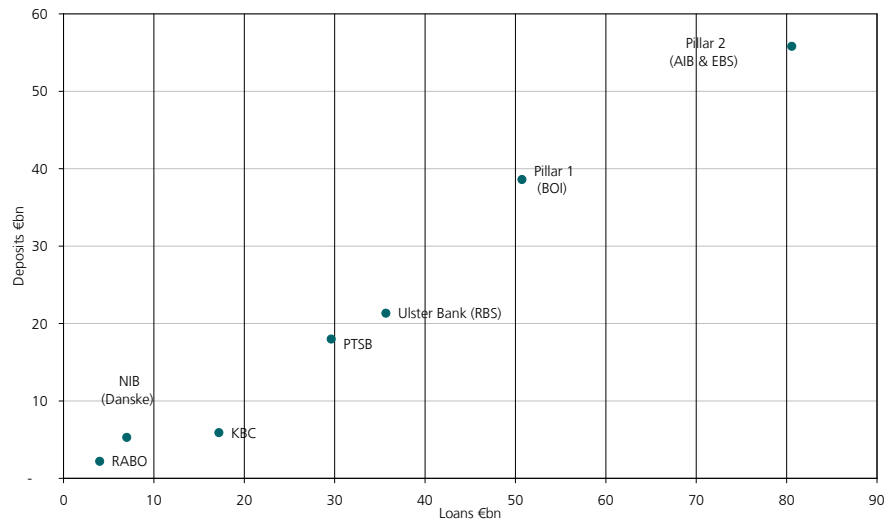
### Onus on pillar banks to assist in flow of credit

The future banking landscape following restructuring and recapitalisation centres on two 'pillar' institutions. Bank of Ireland will represent the first pillar, and the second pillar will consist of a merger between Allied Irish Banks and EBS. What is immediately obvious is the dominant market position of the two pillar institutions in the Irish banking sector. The following chart shows Irish loan and deposit balances for 'going concern' credit institutions in the sector at the end of 2010 – i.e. strips out credit/institutions officially marked for wind-down.

- The total stock of Irish credit is expected to shrink for the foreseeable future, but there is sufficient wind-down taking place elsewhere that it is important the pillar banks look to maintain their exposures to the Irish economy

Given the retrenchment of foreign banks, it is wholly appropriate that the pillar institutions increase the flow of credit to the domestic economy. The total stock of Irish credit is expected to shrink for the foreseeable future, but there is sufficient wind-down taking place elsewhere that it is important the pillar banks look to maintain their exposures to the Irish economy. We believe that the recapitalisations; ECB funding commitment; and banks' deleveraging plans, which focus on overseas exposures, should allow the pillar banks to support a domestic economic recovery.

**Figure 11: Domestic landscape\* for 'going concern' banks**



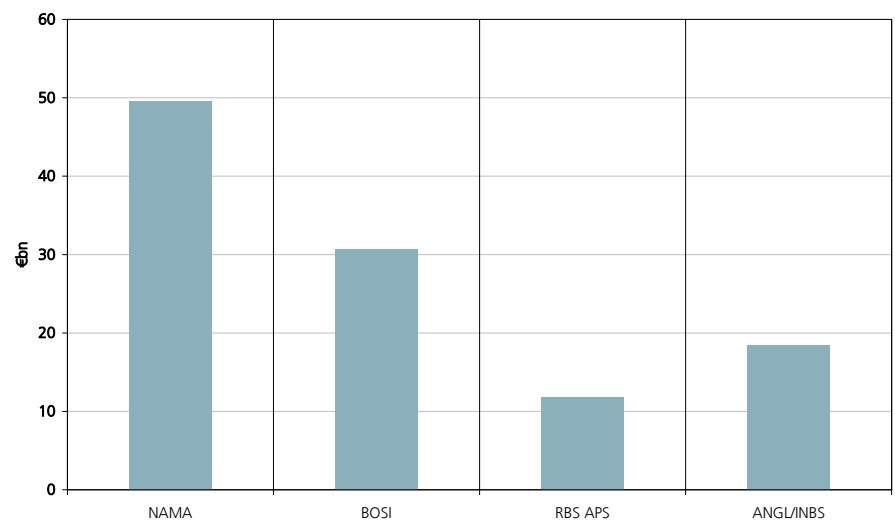
Source: Davy

\* Data taken from company reports based on loans to Irish residents. This may be misrepresentative where loans are used for overseas purposes.

### €110bn of Irish credit already in official wind-down

There is currently €110bn of Irish credit already marked for official wind-down. This includes the Irish loans transferred to NAMA, residual loans in the two non-systemic institutions, Anglo/INBS, Lloyd's Irish operations and the Irish loans included in the UK asset-protection scheme through RBS. PTSB is not included as a pillar institution in the restructured banking landscape and, with a loan-to-deposit ratio of 200%, is unlikely to be a significant player in the medium term. The commitment of the smaller foreign players is also in question given the outsized losses recorded in their Irish books compared with the experience of the remainder of group loans.

**Figure 12: Overview of official credit marked for wind-down**



Source: Davy

The scale of the wind-down (€110bn represents one-third of peak credit to households and non-financial corporates) suggests that the outlined strategy – that the systemic banks' deleveraging should focus on the overseas exposures – is appropriate.

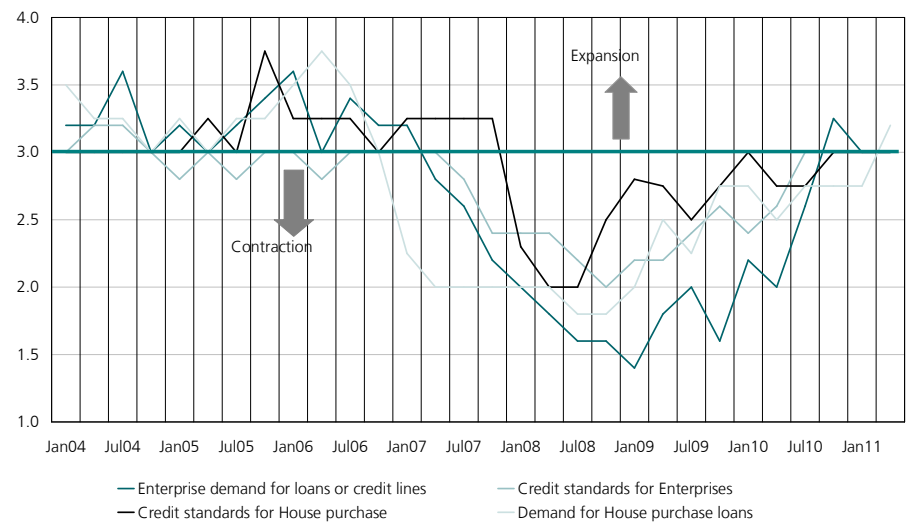
**Improvement in credit demand also required**

The Central Bank lending survey has recorded a persistent downward trend in credit conditions for both households and enterprises over the past five years. The pillar banks should be in a position to improve supply conditions. However, loan targets and performance monitoring will remain important so that credit extension can improve in spite of the group's top-down deleveraging targets. In this regard, a touted credit guarantee scheme for SMEs may be supportive at the margin as the SME sector's own financial position remains in distress.

- Loan targets and performance monitoring will remain important so that credit extension can improve in spite of the group's top-down deleveraging targets

Customer demand for credit also needs to improve from here to complement any improvement in supply-side conditions. At present this seems some way off due to high unemployment, low consumer confidence, high precautionary savings balances, a continued downward trend in property prices and a weaker outlook for the domestic economy versus the export-oriented sector. However, an improvement in supply-side conditions may prompt a needed recovery in customer demand.

**Figure 13: Overview of bank lending conditions**



Source: Central Bank

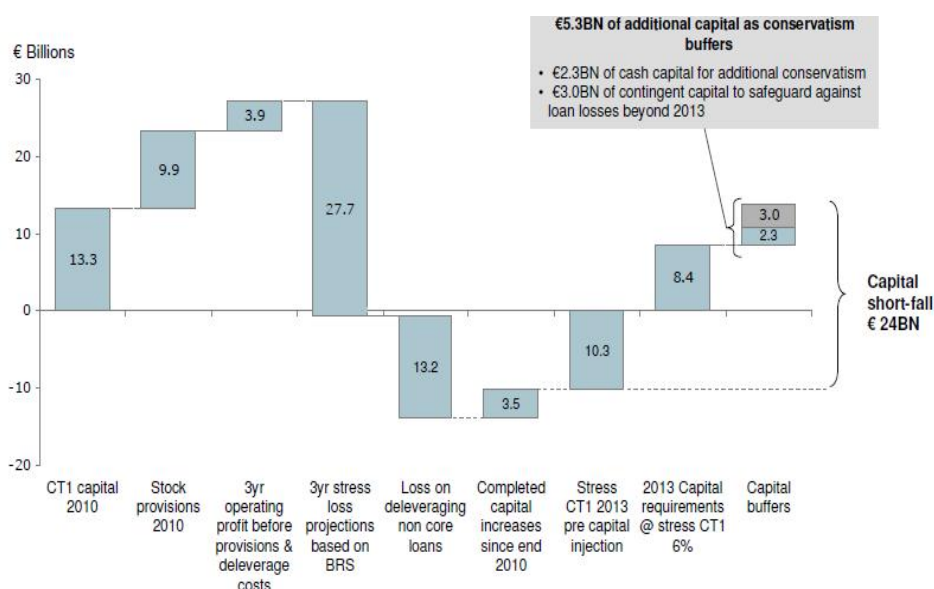
## Overcapitalisation a necessary step to rebuild confidence

### Transparent process will stand up well to international comparisons

The Prudential Capital Assessment Review (PCAR) stress-testing process has stood up well to market scrutiny. The four systemic banks were given prescribed capital targets based on higher capital levels based on stress tests for loan losses in adverse economic scenarios. The process also demanded that the banks hold further capital to facilitate the disposal of non-core loan portfolios below book value and contingency capital for losses materialising after the three-year period of the stress tests. This resulted in a pro-forma core tier 1 ratio of 20.5% for the banks with a further 1.5% of contingent capital on top of this (see our research report, "[Irish bank stress tests: Significant development in sorting out Irish banks and funding environment for Irish sovereign](#)", issued April 1st 2011).

- The stress testing will result in a pro-forma core tier 1 ratio of 20.5% for the banks with a further 1.5% of contingency capital

Figure 14: Capital bridge



Source: Central Bank

- PCAR compares favourably with EBA stress tests, including higher capital threshold, contingency capital and capital to facilitate deleveraging

On a pro-forma end-2010 basis, the recapitalised banks are among the best-capitalised banks in Europe. This will be better understood when the results of the European Banking Authority (EBA) stress tests are published this summer. The PCAR has a higher capital of 6% core tier 1 in an adverse scenario than the 5% target that the EBA will look for. In addition, the PCAR process included a further demand for contingent capital (€5.3bn), which we do not believe will be included in the EBA tests. The PCAR process also builds in €13.2bn of costs relating to the banks' deleveraging, which appears conservative. Most banks are engaged in deleveraging, but this cost will not be in the EBA process. Even when we compare the loan-loss methodology, the PCAR process looks more robust. Unlike the EBA, it allows for loan losses that crystallize beyond the three-year period in question but where the stress was evidenced within the period.

**Table 6: Comparison of Irish banks' end-2010 pro-forma core tier 1 ratios versus European banking peers**

Company name	Country	CT1 %	Company name	Country	CT1 %
<b>PTSB</b>	<b>Ireland</b>	<b>32.0</b>	DnB NOR ASA	Norway	9.2
<b>Allied Irish Banks/EBS</b>	<b>Ireland</b>	<b>22.0</b>	BNP Paribas SA	France	9.2
<b>Bank of Ireland</b>	<b>Ireland</b>	<b>16.0</b>	Erste Group Bank AG	Austria	9.2
UBS AG	Switzerland	15.3	NORD/LB	Germany	9.1
Rabobank Group	Netherlands	14.2	Nordea Bank AB	Sweden	8.9
Credit Suisse Group AG	Switzerland	12.7	Banco Santander SA	Spain	8.8
Nationwide Building Society	UK	12.2	Raiffeisen AG	Austria	8.7
Dexia SA	Belgium	12.1	Deutsche Bank AG	Germany	8.6
Standard Chartered Plc	UK	11.8	La Caixa	Spain	8.6
La Banque Postale	France	11.0	UniCredit SpA	Italy	8.5
SEB AB	Sweden	10.9	Crédit Agricole SA	France	8.4
Barclays Plc	UK	10.8	Société Générale SA	France	8.3
KBC Group NV	Belgium	10.7	Groupe BPCE	France	8.0
RBS Group Plc	UK	10.7	Landesbank Berlin AG	Germany	7.9
HSBC Holdings Plc	UK	10.5	Intesa Sanpaolo SpA	Italy	7.9
ABN AMRO Group NV	Netherlands	10.4	Svenska Handelsbanken AB	Sweden	7.7
Lloyds Banking Group Plc	UK	10.2	DZ Bank AG	Germany	7.7
Danske Bank A/S	Denmark	10.1	Banco Financiero y de Ahorros SA	Spain	7.0
Swedbank AB	Sweden	10.1	UBI Banca SCpA	Italy	7.0
Commerzbank AG	Germany	10.0	Banco Popolare	Italy	5.7
ING Bank N.V.	Netherlands	9.6	WestLB AG	Germany	2.5
BBVA SA	Spain	9.6			

Source: Davy; company accounts

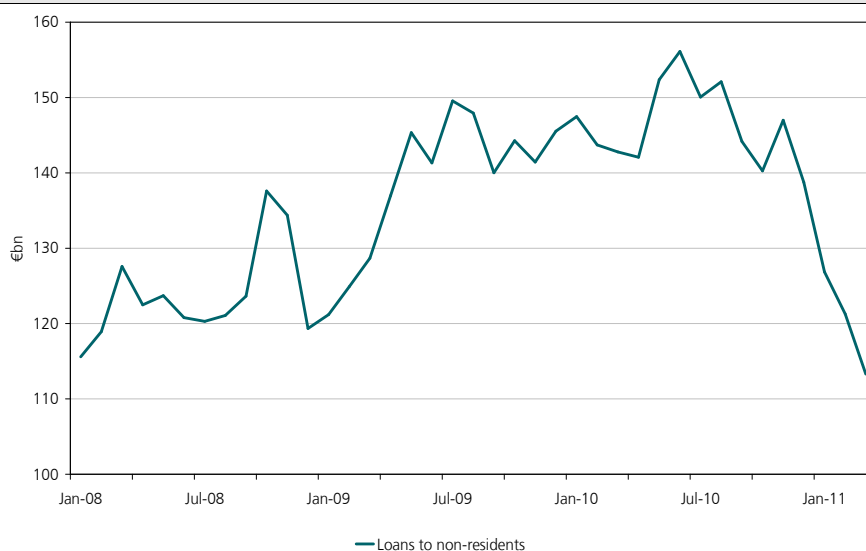
### Deleveraging process least understood and indicates further surplus capital

The prudential liquidity asset review (PLAR) requires banks to reduce their loan books by €60bn (€73bn net) to arrive at a required 122.5% loans-to-deposits ratio by end-2013. The stress test then assumes that the banks require €13.2bn of capital to facilitate this deleveraging. The Central Bank assumes that €25bn of the loan book matures/repays and that there will be €35bn of disposals. In our view, this implies a loss rate assumption of 30%+ against these disposals.

- The gross loss rate for the disposed, mostly overseas loans is 30%+

The deleveraging will focus on the banks' overseas exposures. In this regard, the assumption of €25bn of maturations looks achievable as loans to non-residents from the covered banks have fallen by at least €43bn from their peak in June 2010 to €113bn at end-March 2011 (NAMA may account for at least half of this). A 30%+ loss assumption also looks conservative given the overseas bias and the better performance compared with the Irish portfolios. Market reports regarding the progress of the banks' overseas disposals also support our view, and there may be €3bn of surplus capital allocated to the PLAR process.

Figure 15: Covered banks' loans to non-residents



Source: Central Bank

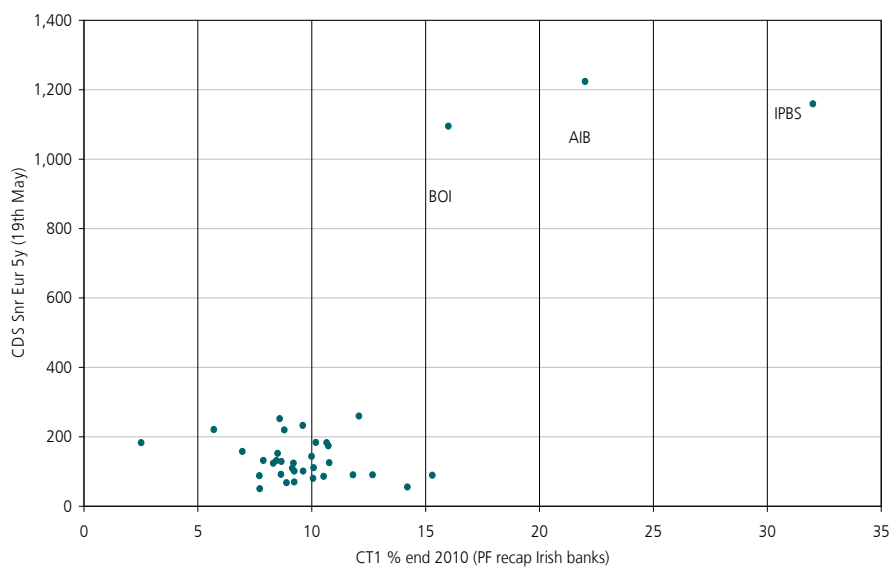
### Solvency concerns persist amid sovereign debt fears

Despite the stress-testing process, solvency concerns persist. This is illustrated by the graph below, which shows the Irish banks' CDS levels in comparison with the European banks listed in Table 6. Of course, the capital has not yet been injected into the banks and concerns over burden-sharing of bank bondholders refuse to dissipate, the latter not helped by the government's stance that the prospect of burden-sharing for Anglo and INBS is not off the table and by the aggressive stance taken towards subordinated bondholders under the Credit Institutions Stabilisations Act (see our research report, "[Subordinated debt: Minister adopts the 'Big Stick' approach](#)", issued April 15th 2011).

- The linkages between the banks and state will be slow to unwind as guarantees remain in place and the banks' liquid asset portfolios contain c.€12bn of sovereign exposure and €30bn of NAMA bonds

But, more specifically, the sovereign's debt problems overshadow the banks' recovery. The linkages between the banks and state will be slow to unwind as guarantees remain in place and the banks' liquid asset portfolios contain c.€12bn of sovereign exposure and €30bn of NAMA bonds. The baton has now been passed from the banks to the economy to prove itself. If the economy can stay the guided course, as outlined in the stability plan, then the relationships between banks and the sovereign can become a positive factor rather than a negatively reinforcing one.

Figure 16: Comparison of CDS versus CT1 ratio for Irish versus European banks



Source: Bloomberg; Davy

## Deleveraging to reduce monetary reliance and state guarantees

### Monetary support set to fall from here

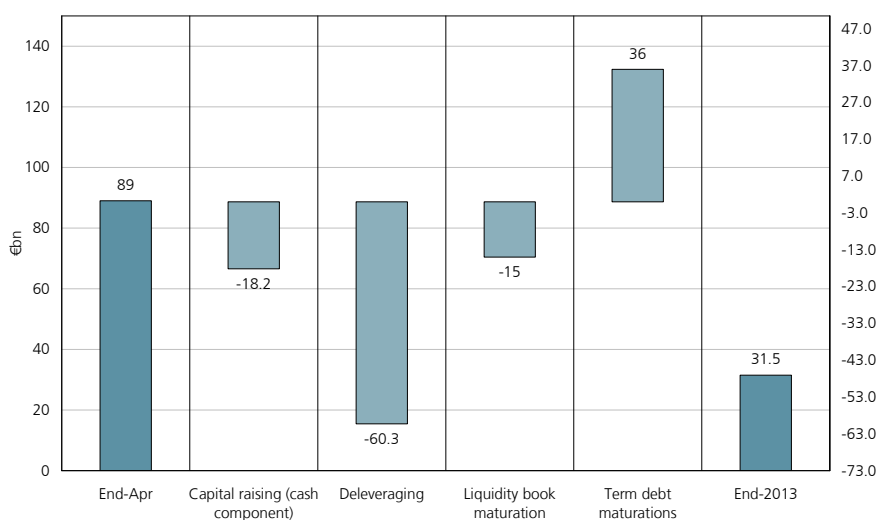
The planned €60bn of gross deleveraging outlined as part of the PLAR exercise will help the four systemic banks to reduce their total monetary reliance. The more expensive borrowings under the Irish Central Bank's emergency liquidity assistance (ELA) facility will be reduced first, which will also help to decrease the state's contingent liabilities. Also, the threat of removal of the NAMA 2 loans if deleveraging does not proceed at pace and ECB oversight will ensure that the deleveraging is not back-ended in the hope of a supportive market recovery.

- Monetary borrowing for the systemic banks is set to fall by nearly €60bn out to end-2013

In our view, total monetary borrowing from the four banks at end-April was c.€89bn. If we assume, as per the stress testing methodology, that Irish banks are unable to tap wholesale markets (even at the short end) and zero deposit growth, then we believe that monetary borrowing will fall by nearly €60bn out to end-2013.

In addition to loan book sales and wind-downs, the banks will also benefit from an estimated €18bn cash contribution from the recapitalisation (LME exercises neutral or cash-negative). Liquidity book maturations will also help and could represent at least €15bn – the banks had €74bn of available for sale (AFS) assets and NAMA bonds at end-2010 (PF for deposit transfers) – especially large in the context of shrinking balance sheets. These positive developments will, however, be offset by €36bn of term debt maturations in the period.

Figure 17: Movements in monetary reliance for systemic banks



Source: Davy

- The reduction in the €55bn of monetary reliance for Anglo/INBS will be a slower process and will be a function of promissory note amortisation and loan repayments/disposals over the ten-year wind-down period
- The explicit government commitment to the Irish banks stands at €163bn. This compares with €440bn at the outset of the previous CIFS guarantee.

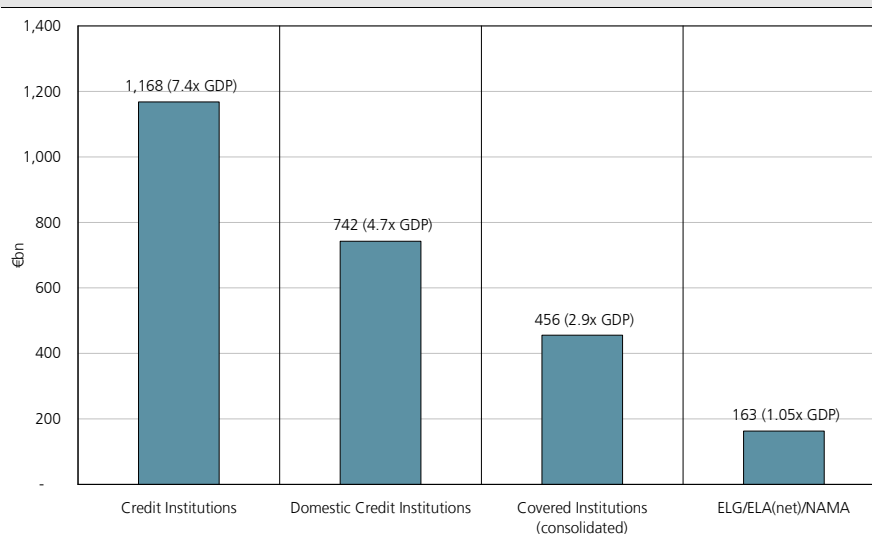
The reduction in the €55bn of monetary reliance for the two non-systemic banks will be a much slower process. It will be a function of loan repayments/disposals over the anticipated merged entity's ten-year wind-down and annual cash-receipt from the amortisation of the €31bn of promissory notes. Maturation of the outstanding €6.7bn of bonds (€3bn guaranteed, €3.7bn unguaranteed) will offset this.

### Linkage between sovereign and banks to slowly unwind

The recapitalisation and deleveraging of the banks will result in a further unwinding of the linkage between the sovereign and the banks. The explicit commitment has already fallen significantly from the €440bn of guaranteed liabilities in place at the outset of the original credit institutions financial support (CIFS) scheme. At end-2010, the explicit commitment was €163bn, which is a combination of liabilities guaranteed under the eligible liabilities guarantee (ELG) scheme and includes own-issued debt as well as NAMA bonds and borrowing from the Irish Central Bank's ELA facility (net of promissory notes, otherwise a double-count). This explicit commitment was little changed in our view at the end of April (inclusive of own-issued debt).

This €163bn of liabilities compare with a consolidated €456bn balance sheet for the covered banks at end-2010. The quantum is also far less than the €1.2tn of banking assets in Ireland that include international banks (with no interaction with the domestic economy other than employment) and routinely misreport the state's banking liabilities. Similarly, this large international presence routinely results in inaccurate reports of Irish banks' overseas exposures. The covered banks' exposure to Greek and Portuguese debt is less than €300m, far lower than that reported from commentators citing data from the Bank for International Settlements (BIS).

Figure 18: Irish banking assets and explicit government commitments (end-2010)



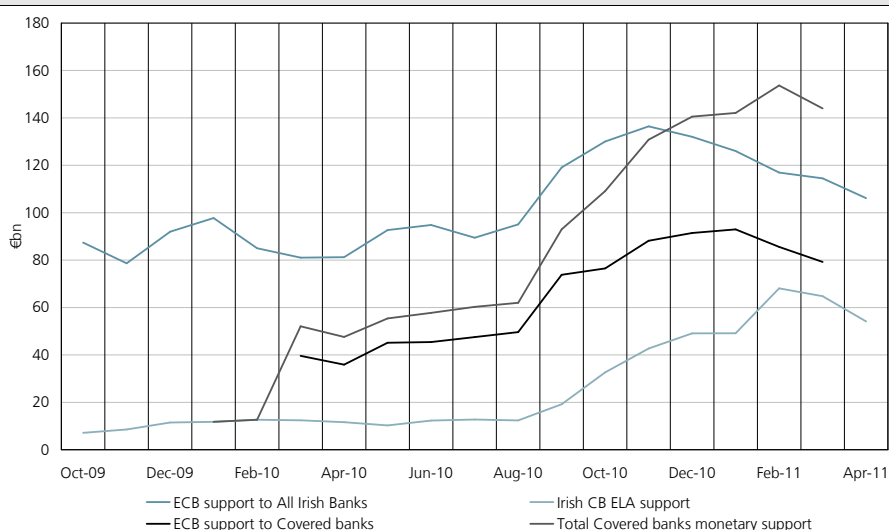
Source: Davy

### Ongoing monetary support to underpin restructuring

With both the banks and the sovereign locked out of the funding markets and unlikely to return any time soon, ongoing monetary support is essential to ensure the banks' viability. The banks' borrowing from monetary sources peaked at €154bn in February this year before falling to €145bn in March – €79bn from the ECB and €66bn from the ELA. This reliance fell further still in April, as evidenced by the €11bn decline in reported ELA borrowing to €53bn and the €8bn decrease in borrowing by all credit institutions (inclusive of international players). Full figures for the covered banks are not available until the end of the month.

The decline in Irish banks' reliance on monetary borrowing will be first led by the cash contribution from the capital injections. This effect is evident already as bailout money is placed on deposit with the banks in advance of recapitalisation. The cash asset will remain when the recapitalisation occurs as the banks' liabilities are replaced with core equity. After this initial boost, deleveraging will be a function of loan repayments and disposals which, as prescribed under PLAR, will be a three-year process. Therefore the banks will maintain a significant monetary borrowing requirement out over the next few years.

Figure 19: Irish banks' monetary reliance



Source: Central Bank; Davy

- The ECB gave explicit support to the Irish banks after the stress tests – the minimum threshold for collateral eligibility for Irish debt was suspended and liquidity support will continue to be made available

It was important that the ECB gave explicit support to the Irish banks following the publication of the stress tests. The minimum threshold for collateral eligibility for Irish debt was suspended, thus ensuring that Irish banks could avoid a liquidity event through exhaustion of eligible funding collateral. But the ECB also welcomed the 'rigorous assessment' of Irish banks' capital needs and indicated that the banks' solvency will ensure that the Eurosystem will continue to provide liquidity to banks in Ireland.

This support from the ECB supports the restructuring of the Irish banks. It allows an orderly deleveraging over three years, which is why

the 30%+ loss assumption in PLAR that we identified earlier looks conservative. In our view, the aggressive stance shown towards subordinated creditors demands that the stress test's adverse scenario for funding – where banks are unable to re-engage with funding markets out to end-2013 – also needs to be facilitated with this monetary support.

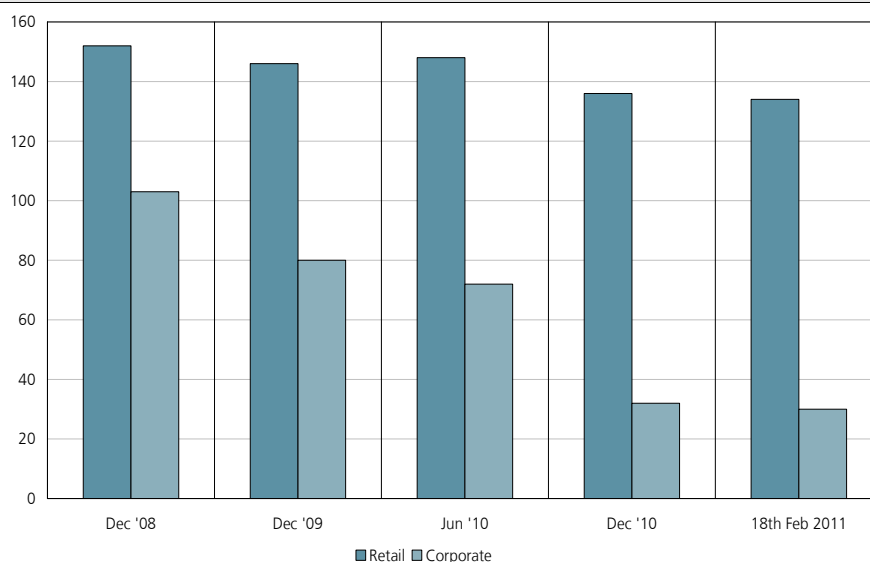
- A medium-term facility would be helpful as it would give investors confidence, particularly if the reports are true that the ECB threatened the removal of funding support as a bargaining chip in negotiations with the Irish government prior to the bailout

It is true that the banks did not get a medium-term facility from the ECB that was widely touted in advance of the stress tests, which is a disappointment. However, medium-term support is to be provided as the ECB is set to persist in offering short-term financing, which the banks will roll into the medium term. A medium-term facility would still be helpful, as indicated by the IMF's recent commentary on Ireland. It would give investors confidence, particularly if the reports are true that the ECB threatened the removal of funding support as a bargaining chip in negotiations with the Irish government prior to the bailout.

A key determinant of the quantum of monetary support is the stability in bank deposits. The chart below was published in the stress test details and shows that at the end of 2008 the retail/corporate deposit mix was 60:40. In mid-February 2011, this mix had changed to 81:19 as the bulk of the deposit outflows have been experienced in the banks' corporate books. Although deposit outflows have continued year-to-date, the rate of outflow has slowed significantly compared with the latter part of last year. It is hoped that deposits should stabilise on the back of the stress testing and resultant recapitalisation. Even if this takes some time to achieve, outflows will be smaller as the less stable corporate book is now a smaller component. Unfortunately, the upside potential to recapture lost corporate deposits requires positive ratings action, which is unlikely to occur in the near term.

- Deposits balances should stabilise following the stress testing and recapitalisation. Downside risk is lower as the corporate book, where most of the outflows have taken place, is now at a low base.

**Figure 20: Retail and corporate deposit movements for the covered banks**



Source: Central Bank

## Irish sovereign more worthy than given credit for

### Public indebtedness on the rise globally, as are default concerns

For many years, a progressive rise in unfunded government liabilities arising from pension and healthcare contingencies has focussed investor attention on the longer-term solvency of many advanced economy governments. However, such concerns have been brought into even sharper relief by the aftermath of the global credit crisis, given the fairly explosive increase in overall public indebtedness. According to the latest IMF forecasts, the average debt/GDP ratio of advanced economies will this year breach the 100% threshold for the first time in the post-World War 2 era, compared with 78% in 2007.

- According to the latest IMF forecasts, the average debt/GDP ratio of advanced economies will this year breach the 100% threshold for the first time in the post-World War 2 era

The recent spike in public deficit and debt levels is attributable to the "automatic stabiliser" consequences of a virulent global downturn, to the discretionary fiscal stimuli which counteracted such a downturn and, most egregiously in Ireland's case, to the enforced public capital injections and assumed contingent liabilities for many highly distressed financial sectors.

**Table 7: Public debt metrics**

% GDP	Gross debt		Budget balance		Struct primary balance	
	2010	2011	2010	2011	2010	2011
Germany	83	83	-3.3	-2.3	-0.3	0
Japan	220	229	-9.5	-10	-6.4	-7
UK	80	86	-10.4	-8.6	-5.7	-3.6
US	92	100	-10.6	-10.8	-5.9	-6.4
Portugal	93	100	-9.1	-5.9	-3	0.6
Ireland	96	111	-32.4	-10	-6.7	-4.5
Italy	119	120	-4.6	-4.3	1.3	1.7
Greece	143	152	-10.5	-7.4	-3.1	0.3
Spain	60	64	-9.2	-6.2	-6.1	-3.1

Source: IMF

### Euroland sovereigns under the microscope

Although investor (and rating agency) concerns regarding sovereign default risk are now becoming broad-based, it is the bond markets of many Euroland governments that have been singled out for particular opprobrium. The defining characteristic of the Euroland sovereign credit crisis is that of diminished funding capabilities for debt-laden governments in a monetary union compared with the options otherwise available outside of that union. In essence, EMU members raise debt in a currency over which they no longer exercise issuance control, thus rendering them vulnerable to a liquidity shock (and potential default) if denied refinancing by financial market participants.

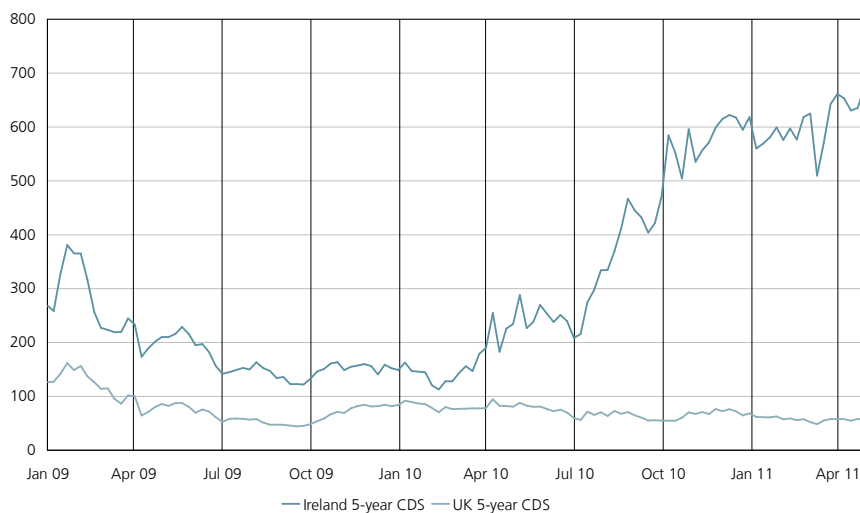
- The defining characteristic of the Euroland sovereign credit crisis is that of diminished funding capabilities for debt-laden governments in a monetary union compared with the options otherwise available outside of that union

It is instructive to note that the public deficit and debt metrics currently facing the Irish authorities are not substantially removed from those of their UK counterparts. However, such inference could not readily be drawn from their respective CDS pricings, whereby a virtual chasm exists between the implicit default probabilities of both sovereigns. The

- With quantitative easing, debt monetisation and/or currency debasement available as last-resort options for UK financing needs, the scope for any market-induced sovereign default is essentially nullified

simple explanation here stems from the UK's vastly superior refinancing capability, based on continuous control of its own debt-issuing currency. With quantitative easing, debt monetisation and/or currency debasement available as last-resort options for UK financing needs, the scope for any market-induced sovereign default is essentially nullified.

Figure 21: Ireland and UK sovereign CDS (5 years)



Source: Bloomberg

- The misdiagnosis of Euroland's sovereign debt crisis continues to endure

**A solvency or liquidity crisis?**

From this perspective, the misdiagnosis of the Euroland sovereign debt crisis as a solvency rather than liquidity problem is all too apparent. However, the potential for a liquidity crisis to morph into a solvency crisis is also clear, if a sustained increase in sovereign bond yields brings a nation's debt-servicing burden to the limits of sustainability.

EMU participants may then become trapped in a self-fulfilling spiral of rising yields, during which time investors progressively withdraw their market support on fears of escalating default risk. In this way, the more investors fear insolvency, the more a sovereign is actually threatened with insolvency, absent the circuit-breaking interventions of collective EMU liquidity support.

Of course, this is precisely the form of intervention mechanism agreed by EU leaders in creating the temporary EFSF this time last year. However, the fractious debate surrounding its permanent replacement, viz ESM, from mid-2013 onwards, not to mention this month's unseemly spat over a "reprofiling" of Greek debt, suggests that the misdiagnosis of Euroland's sovereign debt crisis continues to endure.

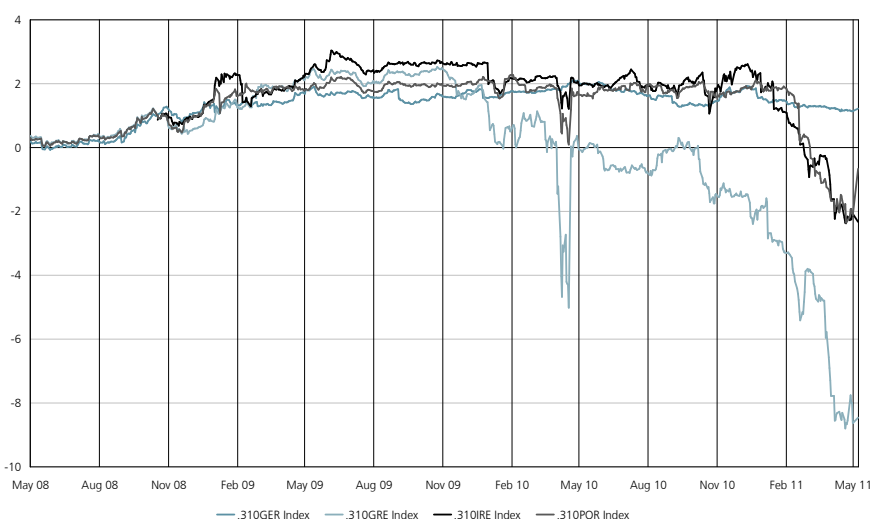
- The focus of many leading politicians and market participants on (orderly) debt restructuring as an unavoidable end-game for the current crisis implies that solvency fears still predominate

The focus of many leading politicians and market participants on (orderly) debt restructuring as an unavoidable end-game for the current crisis implies that solvency fears still predominate, notwithstanding the exceptional fiscal consolidation efforts now imposed on Greece, Portugal and Ireland.

To be sure, the solvency of the Greek sovereign remains an open question, given the enormous burden of public indebtedness that has now transpired. The ambitious multi-annual EU/IMF programme of budgetary adjustment, privatisations and economic restructuring aims to restore Greece's public finances onto a more sustainable debt trajectory, all the more so if refinancing assistance continues to be proffered at favourable rates.

Unfortunately, investors continue to harbour serious misgivings about the collective political resolve to shepherd the Hellenic Republic towards a sustainable debt path. In part, this reflects concern over potential reform fatigue in Greece, but even more particularly on the willingness of certain core economies to sustain financial assistance in the face of domestic political opposition. Debt restructuring fears surrounding Greek debt have reached fresh peaks, and are graphically betrayed by that grotesque inversion of the Greek yield curve, with contagion effects similarly displayed along both the Portuguese and Irish curves.

**Figure 22: Euroland yield curves (3/10 years)**



Source: Bloomberg

### Ireland struggling to disentangle sovereign and bank credit risks

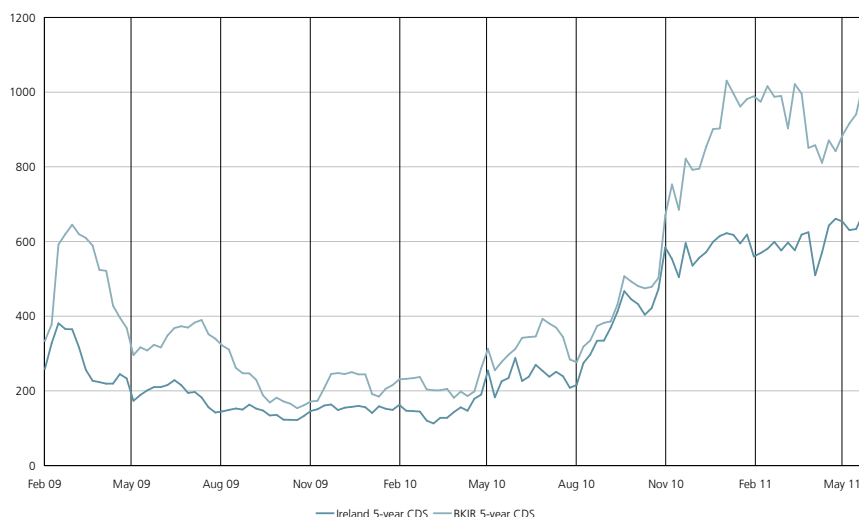
The issue of Irish sovereign solvency has been inextricably linked with that of the domestic banks since the onset of the crisis. This link was initially forged by the state's guaranteeing of substantial bank liabilities at end-September 2008, and has been cemented by the crystallisation of banking sector loan losses and ensuing state-sponsored recapitalisations. The Irish sovereign's cumulative financial participation in banking sector stabilisation (via borrowings and reorientation of existing resources) will likely exceed €65bn (42% of GDP), by some distance the most expensive banking rescue operation of the modern era.

- The Irish sovereign's cumulative financial participation in banking sector stabilisation (via borrowings and reorientation of existing resources) will likely exceed €65bn (42% of GDP)

Understandably, this acute burden on the state's resources has proved deeply unpopular politically. It has also unnerved the investment community, thereby triggering a succession of adverse feedback loops between the sovereign and bank funding markets over the past couple of years. Following earlier failed attempts to stabilise investor sentiment,

the comprehensive PCAR/PLAR programme of bank recapitalisation and deleveraging has the potential to transform feedback loops into a more positive dynamic. However, this process will take time to evolve, leaving the complete disentanglement of Irish sovereign and bank credit risk to await the wind-down of residual contingent liabilities in ELG, ELA and NAMA space.

**Figure 23: Irish sovereign and bank CDS**



Source: Bloomberg

### Rating agencies pro-cyclical in their bond market impact

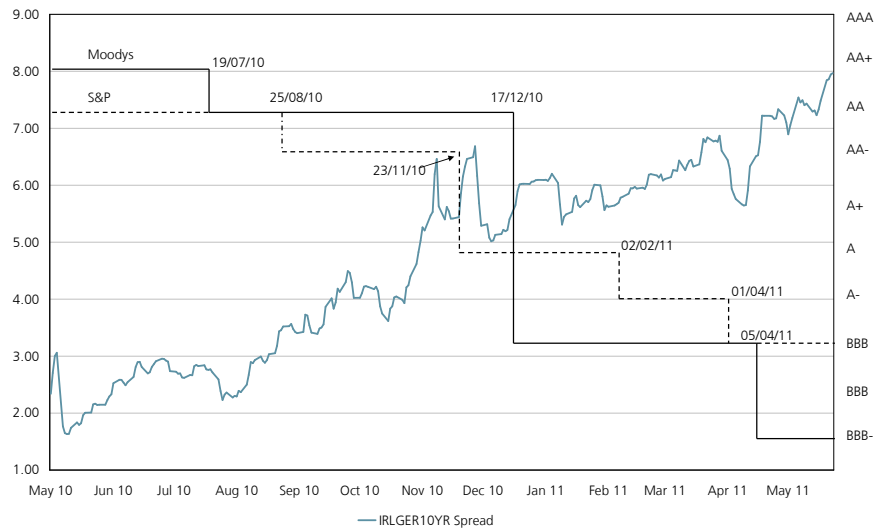
The crystallisation of contingent banking liabilities (both actual and anticipated) has also been a key driver behind the various rating agency actions against the Irish sovereign over the past ten months. However, their interventions have proved to be somewhat erratic, and at times inconsistent, thus further fanning the flames of debt market instability.

Recall, in this context, Moody's decision last July to place Ireland on stable outlook as AA credit, its accompanying statement affirming that Ireland had "turned a corner" in its policy stabilisation efforts. Yet, within five months, the agency had seen fit to effect a five-notch downgrade on the sovereign rating, with a further two-notch reduction, to BBB- equivalent, delivered in early April.

Unquestionably, Ireland's creditworthiness has been negatively impacted during the past ten months, both by the increased financial burden of banking sector stabilisation and by the more cautionary outlook surrounding domestic economic recovery. However, the scale of the rating agency downgrades seems disproportionate in this context, and may be better explained by the acute deterioration in sovereign financial strength resulting from sharply higher bond yields. If so, then the rating agencies have themselves become embroiled in a further adverse feedback loop with the Irish bond market, whereby rising yields have begotten ratings downgrades in a mutually reinforcing debt-spiral.

- Unquestionably, Ireland's creditworthiness has been negatively impacted during the past ten months; however, the scale of the rating agency downgrades seems disproportionate in this context

**Figure 24: Irish yield spreads and credit ratings**



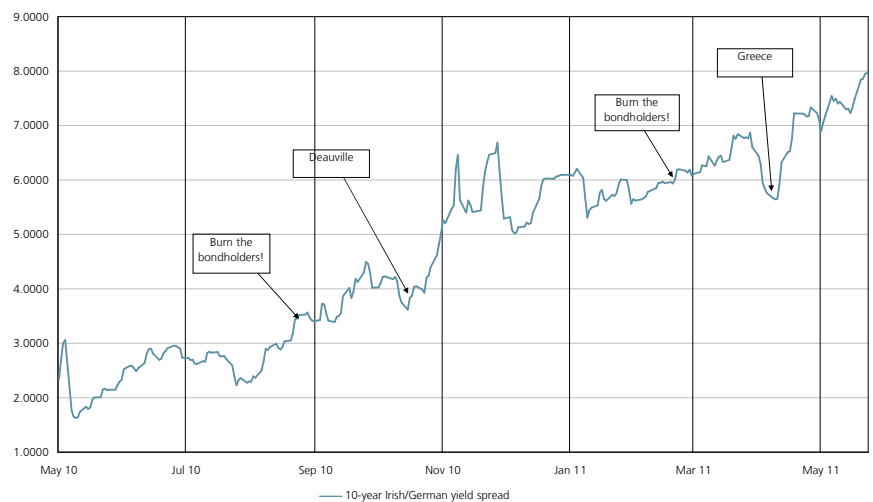
Source: Bloomberg

**Can pay, won't pay?**

Optically, the rising trajectory of Irish bond yields reflects market concern over the "ability" of the sovereign to service its debt obligations into the medium term. However, it also partly reflects investor unease regarding Ireland's "willingness" to pay, this consequent of the incessant "burn the bondholder" antagonisms towards subordinate and senior creditors of the Irish banking system. Although successive Irish governments (and indeed all political parties) have been emphatic regarding the inviolability of sovereign debt, a jittery investor base has begged to differ, not least when set against the more threatening backdrop of ESM proposals for private creditor "bail-in".

- Although successive Irish governments (and indeed all political parties) have been emphatic regarding the inviolability of sovereign debt, a jittery investor base has begged to differ

**Figure 25: Irish yield spreads and political "interventions"**



Source:

### Irish solvency achievable, affordable and deliverable

The spectre of the ESM will doubtless cast a dark shadow over the Irish government bond market for some time yet. Investors will continue to discount the prospect of Ireland being ultimately bounced from one back-stopped financing programme (EFSF) into another, but this time with the added threat posed by a Debt Sustainability Analysis (DSA) test on Irish solvency. In the event that Ireland failed this test, a restructuring of sovereign debt (to involve private creditor "burden-sharing") might then be required as a pre-condition for continued loan assistance.

Of course, two years is an aeon in financial market terms, by which time a much clearer picture of Ireland's debt sustainability prospects will likely have emerged. Investor focus in the interim will return to the underlying story of budgetary consolidation and economic recovery potential. The government's medium-term Stability Programme is committed to reducing the fiscal deficit below 3% of GDP by 2015, with the primary balance (ex-interest payments) moving into a surplus position from 2014 onwards. If these targets are delivered, Ireland's debt/GDP ratio is expected to peak at 118% in 2013, with a gradual decline to follow thereafter. Note that such official expectations are now *ad idem* with those of the EU/IMF (120% peak) and S&P (118%).

The whole concept of debt sustainability is riddled with ambiguity, with no particular level of debt/GDP being construed as the threshold between solvency and insolvency for any sovereign borrower. The IMF's treatment of this issue is equally nebulous, with sustainability typically couched in terms of the sovereign's ongoing ability to service its debt obligations without the need for shuddering adjustments in income or expenditure programmes.

In a general sense, debt sustainability requires a stabilisation and subsequent reversal of any debt/GDP advance into elevated territory. Arithmetically, this may be achieved by nominal GDP growth rates at least matching the average coupon rate on outstanding government debt or, to the extent that nominal growth falls short, by an offsetting surplus on the primary budget balance.

On this basis, the task of stabilising Ireland's debt/GDP ratio appears eminently achievable, in light of the actual (and anticipated) debt servicing bill, slated fiscal adjustments and productive potential of the Irish economy. The targeted surplus on the 2014 primary balance (at 1.7% of GDP) implies a nominal growth requirement below 4% to stabilise matters (assuming a blended 5.5% coupon rate). This bar is not set too high, being slightly below trend economic growth (c. 3.0% real) and having regard to the substantial output gap now extant following an exceptional economic downturn.

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**Table 8: Debt stabilisation matrix**

$\Delta$ Debt/GDP		Nominal GDP growth									
		-3%	-2%	-1%	0%	1%	2%	3%	4%	5%	5.5%
Primary Balances	3%	5.5	4.4	3.4	2.4	1.3	0.4	-0.6	-1.6	-2.5	-3
	2%	6.5	5.4	4.4	3.4	2.3	1.4	0.4	-0.6	-1.5	-2
	1%	7.5	6.4	5.4	4.4	3.3	2.4	1.4	0.4	-0.5	-1
	0%	8.5	7.4	6.4	5.4	4.3	3.4	2.4	1.4	0.5	0
	-1%	9.5	8.4	7.4	6.4	5.3	4.4	3.4	2.4	1.5	1
	-2%	10.5	9.4	8.4	7.4	6.3	5.4	4.4	3.4	2.5	2
	-3%	11.5	10.4	9.4	8.4	7.3	6.4	5.4	4.4	3.5	3
	-4%	12.5	11.4	10.4	9.4	8.3	7.4	6.4	5.4	4.5	4
	-5%	13.5	12.4	11.4	10.4	9.3	8.4	7.4	6.4	5.5	5

Source: Davy

Note: Change in debt/GDP ratio for given combination of nominal growth and primary budget balance, assuming blended 5.5% interest rate.

- Debt sustainability is not only achievable for Ireland, but is also affordable

Debt sustainability is not only achievable for Ireland, but is also affordable. The servicing burden of the accumulating debt, at an expected 20.8% of taxation revenue in 2015, is well contained by historical comparison. Sustainability is also deliverable, given Ireland's credible track-record in adhering to fiscal consolidation programmes, with or without the circumscription of an EU/IMF "Understanding".

#### Compelling valuations, but a broken market problem

All things considered, the Irish sovereign has a constructive story to tell, having finally disentangled itself from bank credit risk, and having committed itself to a credible and multi-annual fiscal consolidation programme that is now successfully meeting its targets.

- The Irish government bond market is essentially broken, with miniscule trading volumes and acute volatility a clear deterrent to investor re-engagement

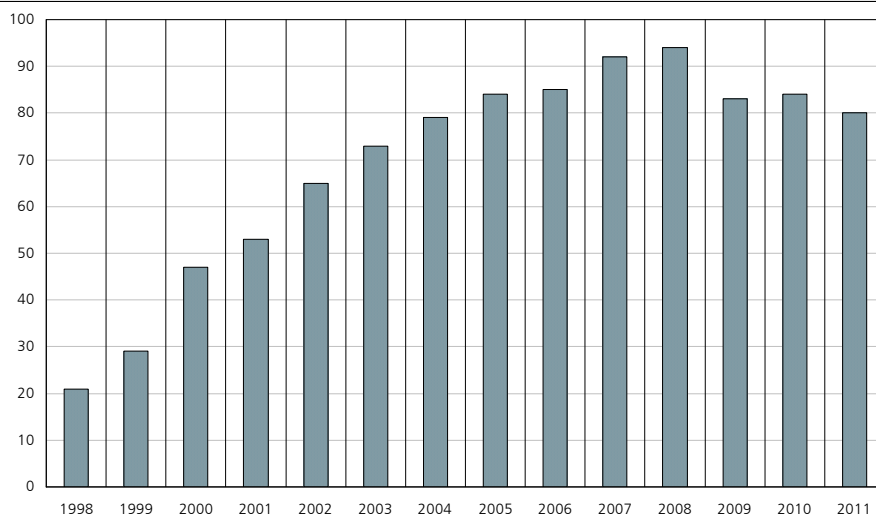
Unfortunately, this story is currently falling on deaf ears. The Irish government bond market is essentially broken, with miniscule trading volumes and acute volatility a clear deterrent to investor re-engagement. Absolute yield levels are undoubtedly compelling (based on actual versus implicit default risk), but the heightened market volatility considerably lessens the attractiveness of risk-adjusted Irish yields compared to the alternatives available elsewhere in fixed income space.

- More fundamentally, the Irish bond market has suffered from a hollowing-out of its traditional overseas investor base

More fundamentally, the Irish bond market has suffered from a hollowing-out of its traditional overseas investor base, these real-money managers having been carried out over the past nine months by the combination of rating agency downgrades and unprecedented market volatility.

Be reminded that Ireland had become dangerously reliant on non-resident support for its government bond market, given the structural tendency towards overseas investments by domestic money managers. Accordingly, Ireland has lacked the "home capital" bias that helps prop other peripheral markets (viz Spain, Italy) during any revival of tensions in the Euroland sovereign debt arena.

**Figure 26: Non-resident holdings of Irish government bonds (%)**



Source: NTMA; Davy

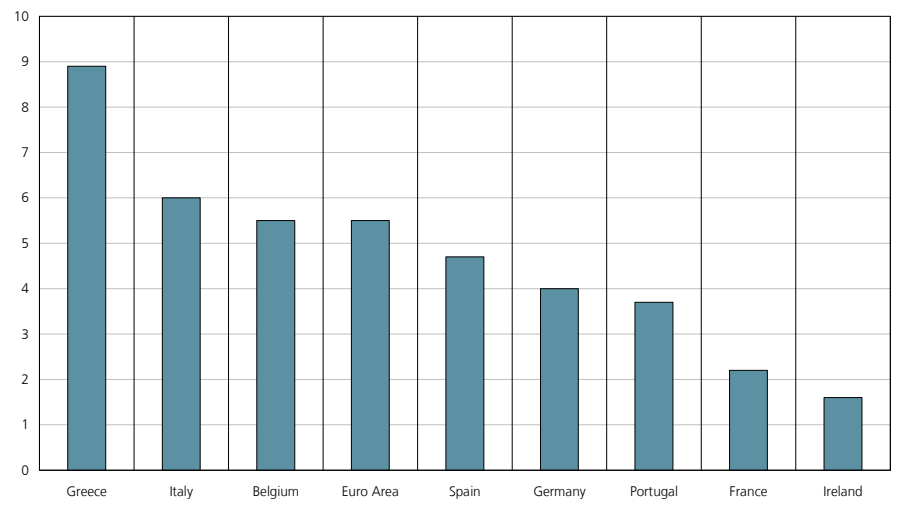
**Current account surplus a potentially key inflection point**

Of course, now that the Irish economy has successfully transitioned from current account deficit to surplus, the "twin deficit" frailties that have plagued a host of peripheral markets during the crisis period no longer apply to the Irish sovereign. In theory, Ireland has now the capacity to domestically absorb the entire borrowing requirements of its fiscal authority, thereby relinquishing its dependency on the kindness of strangers (see our research report, "[Why external balance is important for the Irish economy,](#)" issued May 20th 2011).

However, the theoretical necessity of a current account surplus to absorb whole economy borrowing needs is not in itself sufficient. Sufficiency will stem from a reorientation of domestic investor appetites towards their home markets. This may be achieved via a combination of carrot (yield enhancement) and stick (regulatory change) approaches.

Clearly, domestic bond managers remain every bit as leery of market volatility and Euroland contagion risks as their overseas peers. However, the prospect of legislative change for both public and private pension funds to encourage Irish debt accumulation may engender more of a captive bid domestically on asset-liability matching grounds. Meanwhile, Irish banks have ostensibly significant scope to embrace highly profitable "carry" trades in short-dated government paper on a hold-to-maturity basis, the exigencies of the PLAR deleveraging process notwithstanding.

Figure 27: Euroland bank exposure to sovereign debt assets (%)



Source: Davy

## Conclusion

Ireland remains cut off from international funding markets both in terms of the sovereign and the banks.

### **Credible response domestically, but external ambiguities remain**

Through the PCAR/PLAR assessment, and associated recapitalisation and deleveraging requirements, a coherent plan has been put in place to improve funding conditions for the banking system. Ireland's well capitalised banks will in time have a more secure retail deposit funding base.

Similarly, the fiscal consolidation plan set out in the April 2011 stability update provides a reasonable path towards sovereign debt sustainability, with the interest burden on the national debt remaining well below the levels reached in the 1980s.

However, both the plans for the banking system and fiscal consolidation rest on continued EU/IMF funding support over the medium term, the former through ECB funding of Irish banks and the latter through borrowing from the EFSF/ESM. Current market concerns with respect to Ireland are probably more focussed on the political resolve within Europe to maintain that funding (and on the right terms to attract investment) than on domestic political efforts to consolidate the fiscal position and inject sufficient capital into the Irish banks.

### **Funding clarity is paramount**

Both ECB emergency funding of Irish banks and EFSF/ESM funding of the sovereign almost seem designed to provide exactly the right amount of ambiguity to deter investors from re-engaging. High yields on Irish sovereign and bank debt are attractive to investors, but uncertainty is not.

Funding support for both the banks and the sovereign needs to be put on the right terms so that private investors can re-engage. More clarity and an explicit commitment to maintain funding support over the medium term are required to allay investors' fears. The lack of such a commitment encourages investors to question how the sovereign can re-engage with international bond markets. If there is no exit strategy from the ESM, investors can only question the political will to maintain that support.

There is some irony that the EU authorities insisted that Ireland's fiscal consolidation should be front loaded to reinforce investors' perceptions of the credibility of the budgetary adjustment but have themselves failed to provide that same clarity in their own policy actions.

These concerns are at the heart of recent IMF criticism of the EU policy response. The ECB has failed to put in place a medium-term funding facility for the Irish banks and ostensibly continues to provide only short-term emergency support (with vague signals that such support may be on a medium-term basis). This policy threatens to undermine any benefits from the PCAR/PLAR requirements to overcapitalise the Irish banks. Investors' concerns are understandable given repeated reports that

- The fiscal consolidation plan set out in the April 2011 stability update provides a reasonable path towards sovereign debt sustainability, with the interest burden on the national debt remaining well below the levels reached in the 1980s

- Funding support for both the banks and the sovereign needs to be put on the right terms so that private investors can re-engage

- The ECB's role as lender of last resort to the banking system is not clear to investors

the threatened withdrawal of ECB funding had been used as a bargaining chip in EU negotiations. However, the reality is that ECB support cannot be withdrawn until private sector funding of the Irish banks re-emerges.

Hence, the IMF has recommended that the ability of Irish banks to regain market-based funding would be supported by the medium-term availability of Eurosystem financing. That such a policy would be more effective in securing the desired outcome of weaning the Irish banks off ECB support has not yet led to a change in policy.

Ambiguity around the ECB's support of the banks also heightens investors' perceptions of the Irish sovereign's contingent liabilities through the ELA and ELG schemes. So the current ECB policy undermines the ability of the sovereign to access private markets.

#### **High yields provide the optimal exit strategy from official funding**

It is telling that the IMF has recommended a more flexible upgrade of the current EFSF arrangements rather than commending the current plans for the ESM. The terms of ESM funding suggest that it will be an uphill battle to bring back creditors to the sovereign debt market. So for both the banks and the sovereign, the pace of their re-entry to private markets is likely to be slow.

Nonetheless, our central view is that the EU authorities will eventually put in place the necessary funding requirements. If investors can peer through the fog of the EU authorities' policy response, then the highly attractive valuations of Irish sovereign and bank debt will become all the more apparent.

- Our central view is that the EU authorities will eventually put in place the necessary funding requirements

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